

Securities Lending Cash Reinvestment Strategy

The CalPERS' Fixed Income staff has always strived to match investment horizons to the needs of fund participants. In 2003, the CalPERS Investment Committee approved the Limited Duration portfolios that were designed to be utilized by various CalPERS constituents that desire portfolios with expected risk and return characteristics that exceed those typically found in traditional money market funds and securities.

The Limited Duration portfolios strive to earn a return premium versus traditional short duration assets by purchasing a broader universe of short duration securities than those typically available to traditional money market portfolios.

Expanding the allowable universe of short duration securities provides the opportunity to take advantage of structural aspects inherent in the short duration sector. Traditionally there are three strategies that provide incremental alpha opportunities for short duration investors:

- extending duration out the yield curve
- accepting lower liquidity
- investing down the credit spectrum

Investors have historically been able to earn incremental return for extending investment duration in the front-end of the yield curve. Under normal market conditions, a positively sloped yield curve has historically rewarded duration extensions.

Investors are also able to earn incremental return for purchasing less liquid short duration securities that offer incremental return in exchange for less liquidity. The ability to purchase less liquid securities is dependent on identifying a "core" portion of a portfolio that is highly unlikely to be liquidated.

Finally, incremental return potential is available by purchasing securities that are not in the rating agencies highest rating category. By adding diversified holdings in non-AAA rated investment grade securities, incremental yield can be added to a short duration portfolio.

The strategy utilized by the CalPERS securities lending group is to have our external partners manage the cash reinvestment liquidity needs and continue transitioning the "core" portion of the securities lending reinvestment assets from external managers to internal fixed income unit. The "core" nature of a significant portion of the securities lending cash reinvestment assets provides the opportunity to take a longer-term perspective horizon when it comes to the management of the assets. A longer investment time horizon allows trading off the potentially increased monthly variability of investment returns in exchange for higher expected long-term returns.

Another benefit to CalPERS of utilizing the Limited Duration portfolios for the "core" component of the securities lending cash reinvestment is the elimination of the revenue sharing compensation model that exists with external cash reinvestment managers.